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SUBJECT: FRENCH ECONOMY IMPROVING, BUT UNREST MAY LEAVE MARKS

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11. (U) SUMMARY. While the recent unrest in France may have dominated the headlines, the GOF has attempted to counter the negative reports with good economic news. GDP growth increased 2.8% (annualized) in the third quarter, much more than expected. The unemployment rate decreased to 9.8%, and inflation remains moderate. For 2005, GDP growth should easily reach 1.5%, so the GOF remains confident in its prediction of 2.0-2.5% GDP growth for 2006. The unrest will nevertheless leave its mark on the economy: the fall of the euro should help boost exports and necessary reconstruction will help energize the construction sector. On the negative side, the tourism and insurance sectors are suffering and over the medium term foreign direct investment may decrease. If fulfilled, new social spending promises will make reducing the budget deficit to below 3% of GDP more difficult. END SUMMARY.

GDP Increased More than Expected in Q-3

12. (U) Based on the National Statistical Agency (INSEE) flash estimate, GDP (seasonally and workday adjusted) increased 2.8% (annualized) in Q-3 compared with 1.2% in Q-1 and 0.4% in Q-2. This is the fastest growth since Q-2 2004 when GDP increased 3.2% (annualized). This is also significantly higher than the October INSEE's forecast of 1.6%.

13. (U) While the flash estimate did not include a breakdown, GDP growth is likely to have been driven by solid household consumption. Consumption of manufactured products (which accounts for about 30% of consumption) rebounded in July and August, respectively 1.2% and 1.5% compared with June and July, respectively. Consumer spending rose during the summer despite less than robust increases in real disposable income. Consumer optimism may have been boosted by miscellaneous government measures in favor of consumption, and improvement in the labor market.

Unemployment Decreased to 9.8% in September

14. (U) The number of unemployed has been steadily decreasing in the last six months. More importantly, the decrease was significant enough to result in a decrease in the unemployment rate (based on ILO definitions) to 9.8% in September from 9.9% in August, and from its highest level in five years, 10.1% in January and February. The improvement was partially due to government programs to promote job creation in the private and public sectors, and the Social Cohesion Plan, which raises the number of beneficiaries of government subsidized contracts. That said, among those under 25 the unemployment rate remains nearly 22%, about twice the U.S. rate. Youth joblessness runs around 50% in the suburbs where many of the more than 5 million first-and second-generation African and Arab immigrants live.

Exports a Record in September; Industrial Production Up for the Second Consecutive Month

15. (U) The foreign trade deficit narrowed in September to 1.7 billion euros as exports increased 4.6% to a record 31.2 billion euros. Imports increased 2.7% to 32.9 billion euros. French industrial production increased 0.2% in September compared with August, and 1.2% in August compared with July.

Inflation Remains Moderate

16. (U) The consumer price index (seasonally adjusted) subsided to 1.9% in October compared with October 2004, despite increases in consumer oil prices. Consumer energy prices increased 5.0% in October compared with September, mainly due to a 7.3% increase in oil prices, although crude oil prices fell from an August record of 70.85 U.S. Dollar.

Consumer prices excluding energy increased a moderate 1.0% compared with October 2004.

Finance Minister Welcomes Q-3 GDP Growth . . .

17. (U) Finance Minister Thierry Breton went on Europe 1 radio to announce the Q-3 data 30 minutes before the scheduled release by INSEE. He welcomed Q-3 GDP growth, saying it was "very good news", but not a surprise because he has been saying for months that all lights on his indicators for the French economy had "turned to green." He said the two weeks of unrest in French suburbs had little impact on GDP growth, adding that the 200 to 300 million euros increase in social programs in France's suburbs could be easily offset by cutting spending elsewhere. The government promised 5,000 more teachers and 100 million euros for organizations in the troubled suburbs, 70,000 additional scholarships, vocational advancement programs, and five new tax-free zones for investors. Breton expressed confidence that France would enjoy much higher economic growth in the second half than in the first half of 2005, adding that the Q-3 GDP growth of 2.8% showed that "GDP growth of 2.0-2.5% in 2006 is perfectly realistic and achievable." Before the release of INSEE's Q-3 GDP data, the IMF had forecast French GDP to increase 1.5% in 2005 and 1.8% in 2006.

. . . but Fears an Increase in European Interest Rates

18. (U) Bank of France Governor Christian Noyer said that Q-3 GDP growth was encouraging, but he was favorable to an increase in European Central Bank interest rates as "the inflation risk in Europe is the factor that is threatening economic growth the most." He said that the EU inflation rate was close to 2.5%, and might not decrease quickly to 2.0%. Breton, along with his European counterparts, said he was opposed to an increase in ECB interest rates that could kill economic growth. He said, "inflation in France is totally under control, there is no related rise in wages, and the euro is at the right level." Ernest-Antoine Selliere, the French head of UNICE, the European federation of businesses, called for the ECB to not increase interest rates as it would be a negative signal for European economic growth.

Impact of the Unrest on: -- Foreign Direct Investment

19. (U) From a macro-economic point of view, most analysts see the unrest as a mixed bag. The greatest damage from the unrest is the deterioration in France's attractiveness to foreign direct investment. Not surprisingly, the head of the Invest in France Agency (AFII), Clara Gaymard, downplayed the situation, saying that foreign investors understood that a limited group of young people were at the origin of the unrest, not the broader French population, which has requested a return to order. She said that foreign investors focused on the quality of research, training, and infrastructure to define their investment strategies. She disagreed with head of the business confederation MEDEF, Laurence Parisot, who called the economic consequences of the violence "very serious."

-- on the Budget Deficit:

110. (U) The unrest is certain to affect the budget, notably the 2006 budget deficit, which the government is trying to keep below 3% of GDP. The impact of the unrest on the budget may be larger than indicated by Breton. Analysts at Credit Agricole-LCL, France's largest bank, have calculated that to meet its new promises, the government would have to boost budget spending by 2 billion euros. Simply fulfilling its promise to hike spending on urban renewal by 25% would cost 1 billion euros.

-- on the Tourism and Insurance Sectors

111. (U) The tourism sector fears a fall in business during the Christmas period, particularly if heavy news coverage of the unrest continues. Companies offering city tours are especially worried about a drop-off during the holiday season. According to French reports, up to 30% of the trips booked to Paris by travel agencies in the U.S. have been cancelled since the unrest began.

112. (U) The direct losses for the insurance sector due to the unrest are considerable, but the French Federation of Insurance Companies (FFSA) has dismissed any expressions of concern. The FFSA estimated that 20 million euros in claims for the 6,600 cars that were burned, and put total insurance claims, including damage to sports facilities, schools and businesses, at 200 million euros. This compares with 7 million euros in fire damage claims each year in France.

-- on the Building Sector

¶13. (U) The building sector could benefit from the situation as soon as 2006 since all damaged buildings and facilities will have to be rebuilt. Before the unrest, the government had already promised to accelerate the construction of public housing (as part of its Social Cohesion Plan), promising to reach its objective in 18 months, before the June 2007 presidential elections.

Comment

¶14. (U) Some economists believe that relying on consumption as a driver for French GDP growth is a cause for concern. Since consumption depends heavily on consumer confidence, which itself depends largely on employment and wages, strong Q-4 growth cannot be taken as a foregone conclusion. An up tick in inflation or a resurgence of civil unrest could result in a downward correction in Q-4. On the other hand, the fall of the euro in November against the U.S. dollar, which was partially due to a lack of confidence related to the unrest in France, has brightened prospects for exporters, and the drop in energy prices has helped lift European business confidence to a nine-month high in October. Therefore, an increase in exports could partially offset a downward correction in consumption. Stock exchange markets have not reflected anticipations of lower economic growth in the short-term. The blue-chip CAC 40 index increased to 4,541.82 on November 11 due to the rise on Wall Street, the decrease in oil prices, and the decrease in the euro. The index continued increasing on November 14. Importantly, investors have been taking their cues from U.S economic indicators, not the French economic situation.
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